IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

70-52

No. ~~1082~~

UNITED STATES OF AMERICA,
Petitioner,

vs.

MISSISSIPPI CHEMICAL CORPORATION, ET AL.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI IN THE SUPREME COURT OF THE UNITED STATES

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MEMORANDUM FOR THE RESPONDENTS

The Solicitor General, on behalf of the United States of America, has filed a petition for writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in the consolidated cases of Mississippi Chemical Corporation and Coastal Chemical Corporation, Plaintiffs-Appellees v. The United States of America, Defendant-Appellant. This memorandum is filed in behalf of the Mississippi Chemical Corporation and the Coastal Chemical Corporation as respondents to the petition.

RESPONSE TO STATEMENT AND REASONS FOR GRANTING THE WRIT

Three cases have been recently decided by appellate courts involving the taxation of Class C stock in banks for cooperatives formed under 12 U.S.C.A. Sec. 1141, et seq.

The first case was decided by the Court of Claims on September 14, 1969, being *Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F. 2d 1372. A copy of such decision of the Court of Claims is attached hereto as Appendix A for the convenience of this Court. The United States did not attempt to obtain a review of this decision by this Court under Section 1255 of Title 28, U.S.C., and the decision has become final. That case involved Class C stock of the Springfield Bank for Cooperatives.

The second case is that of *M.F.A. Central Cooperative, et al.,* v. *Edwin O. Brookwalter, District Director of Internal Revenue,* 427 F. 2d 1341, decided by the United States Court of Appeals for the Eighth Circuit on June 8, 1970. Petition for writ of certiorari is now pending before this Court in Cause No. 824 at this term of this Court. That case involved Class C stock of the St. Louis Bank for Cooperatives.

The third case is the case at bar in which the decision of the Court of Appeals for the Fifth Circuit was rendered on September 14, 1970, and appears in 431 F. 2d 1320, a copy thereof being attached as Appendix B to the Petition for Writ of Certiorari herein. This case involves Class C stock of the New Orleans Bank for Cooperatives.

The basis claimed for the granting of the Petition for Writ of Certiorari is that there is a conflict between the Circuits arising from these cases. We respectfully disagree with this conclusion for the reasons hereinafter set forth.

QUESTION PRESENTED HERE

Whether, under the differing facts in these three cases there is a conflict, of sufficient importance to warrant the issuance of a writ of certiorari, between the decision of the Court of Appeals for the Eighth Circuit in *M.F.A. Central Cooperative* (on the one hand) and the decisions of the Court of Claims and the Court of Appeals for the Fifth Circuit in *Penn Yan Agway Cooperative* and *Mississippi Chemical Corporation*, respectively (on the other hand).

In each of these cases the taxpayer, as a borrower from the bank, was required by the statute and the loan documents to pay an "interest override", amounting to fifteen per cent of the interest payable upon its loans for each calendar quarter. This "interest override" was credited upon the books of the bank to an account of the taxpayer designated as "Class C Stock". The question in each case was whether the entry of this credit (sometimes referred to as the "issuance by the bank" or the "purchase by the borrower" of Class C stock) constituted receipt by the taxpayer of sufficient value to render such "entry", "purchase" or "issuance" taxable in the full amount of the entry, i.e. $100.00 per share of Class C stock thus entered.

At the end of each year there was also credited to such "Class C Stock" account "patronage refunds". The attributes of these two types of entries were identical. On the appeals in both the Eighth Circuit and the Fifth Circuit and also in the Court of Claims, the United States did not contend that such "Class C Stock", i.e. the entries covering patronage refunds, were taxable either in the full amount thereof or in any amount.

The basic issue determined by each of the three Courts, as to which there was a reasonable difference of

opinion and as to which there was a different finding in each case, is not a question of law, but solely a question of fact—i.e. what portion of each $100.00 paid as "interest override" was in substance and in fact (a) paid for the use of money (either as interest under IRC Section 163 or as an ordinary and necessary business expense under IRC Section 162) or (b) paid for the Class C stock entered upon the books of the bank.

It is implicit in the taxpayer's argument in each of these cases that any portion of each $100 which could fairly be held to have been paid for the Class C stock would not be deductible when paid; such amount would constitute the tax basis of the stock which would determine the profit or loss realized when the stock was disposed of. What all of these taxpayers have contended is that they should be entitled to deduct, either as interest or as a business expense, that portion of the price *purportedly* paid for this stock which was *in fact* paid, not for such stock, but rather solely for the use of money.

Penn Yan Agway Cooperative

~~In~~ *Penn Yan Agway Cooperative, Inc.* v. *United States*, 417 F. 2d 1372, the Court of Claims found that the 15% paid constituted a "surcharge on interest" (p. 1375); "the plaintiff did not receive any special services other than the lending of money from the Springfield Bank" (p. 1376); that shares of Class C stock "gave plaintiff no additional voting rights, no additional right to share in the profits of the bank, and no additional benefits of any kind" (p. 1376); that "the only right they carry and have carried is long-delayed redemption at their bare purchase price" (p. 1378); that "there have been no sales of Class C stock other than issuance by a bank for cooperatives to a borrowing farmers' cooperative. . . Plaintiff reason-

ably believed that there was no market for such stock". (p. 1377.) The Court further held:

> Plaintiff reasonably believed that there was no market for such stock. The fair market value of plaintiff's 4.07 shares of class C stock was established at $6.90 per share as of the time of its acquisition by plaintiff in 1959 by expert stock evaluation testimony adduced by plaintiff.

Without burdening this Response unduly, we point out that the Court held that the difference between value of $6.90 per share and the entry of $100 per share was "interest paid and deductible under Section 163 of the Internal Revenue Code", saying (p. 1378):

> Of course, Congress considered the 15 percent surcharge on interest payable on loans as a means of providing capital to the banks for cooperatives, and the bank realistically and lawfully treated as capital, funds received in that manner. But from the standpoint of plaintiff-taxpayer, this was in reality an increase of the basic interest rate as an experienced cost of borrowing money from the bank, even described in the statute and in the loan agreements as a percentage of interest payable on the loans. Its expenditure of $407, at least in greater part, was in reality an item of cost of conducting its business, and in the absence of compelling law to the contrary, and to the extent that it was a reasonably ascertainable cost, should be offset against plaintiff's income in the taxable year involved, in accordance with the annual accounting principle of the federal income tax laws. This is true whether such ascertainable cost is deemed interest paid under § 163 or an ordinary and necessary business expense under § 162 of the Internal Revenue Code of 1954.

M.F.A. Central Cooperative

In *M.F.A. Central Cooperative* v. *Brookwalter*, the district court concluded that Class C shares in the St. Louis

Bank for Cooperatives had no fair market value at all. This conclusion was reversed by the Eighth Circuit. Although different results were reached in *M.F.A. Central Cooperative* and in the case at bar, a conflict between the Circuits has not arisen because of the wide variation in the evidence in the two cases. The material differences were found by the Court of Appeals for the Fifth Circuit as follows:

> In *M.F.A. Central Cooperative* v. *Brookwalter*, the district court concluded that Class C shares in the St. Louis Bank for Cooperatives had no fair market value at all. This conclusion was reversed by the Eighth Circuit which stated, "While the Class C stock has no established market value, *it has a substantial book value* and while it is likely not worth its par value at the time it is issued, *it certainly has substantial value*". It should be noted that *there is a considerable difference, as to the factors affecting value, between the shares of the St. Louis bank and those involved here.* Note 20.
>
> *Note 20.* From statements contained in briefs filed in this court, it appears that by June 30, 1967 the St. Louis Bank had completely retired its Class A shares and substantially reduced the amount of Class B investment. As a consequence it was able to redeem all Class C shares issued during the fiscal year ending June 30, 1956. The M.F.A. Cooperative had purchased St. Louis Class C shares from other cooperatives, and it appears that transactions between cooperatives were not uncommon.

For convenience of the Court we quote the summary of the evidence in *M.F.A. Central Cooperative* contained in the brief filed by the United States in the District Court:

> Furthermore, plaintiff, as an owner of Class C stock, not only possesses the right to receive par value upon its retirement, but may *freely transfer it to other cooperatives.* Specifically, *plaintiff on three separate*

> *occasions purchased Class C stock from other farm cooperatives* and, indeed, requested the Bank to record the transfer. (Tr. 227; Ex. I.) When this purchased stock was retired, plaintiff received its full par value. (Tr. 230; Ex. J.) Moreover, the freedom to transfer Class C stock is clearly demonstrated by the fact that such shares issued by the Bank during 1956 were *transferred between farmers' cooperatives on 48 separate occasions.* (Tr. 271.) There is no reason to assume that similar transfers did not subsequently take place.

Another fact material to the different result reached by the Eighth Circuit is its further finding:

> It is quite true that it was necessary for the taxpayer to purchase the Class C stock *in order to maintain its eligibility to borrow from the Bank. . . .* The stock a cooperative is required to purchase *serves the additional purpose of being collateral for loans made.*

These findings of fact in *M.F.A. Central Cooperative,* whether they be (a) erroneous upon the record in that case and hence a basis for the writ of certiorari asked by the taxpayer or (b) justified by the record as contended by the United States, cannot justify the granting of a writ of certiorari in this case at bar. To the extent that a conflict appears, the holding of the Court of Appeals for the Eighth Circuit is dicta.

Mississippi Chemical Corporation Case

Contrasted to the facts as found by the Eighth Circuit, the Court in the case at bar found as follows:

> Mississippi Chemical Corporation acquired its qualifying share of Class C stock in 1956; Coastal Chemical Corporation purchased its share in 1957. *Each carried its initial share on its books at the $100 cost, and neither sought a deduction for any part of this expense. These qualifying shares were not involved in the suit below.*

Central to the district court's decision was its finding that the Class C stock, while not worthless, was without any appreciable market value and had at most a nominal value. This conclusion is attributable to the peculiar nature of these shares. Taxpayers could only sell or transfer Class C stock to another qualified farmers' cooperative with the authorization of the Bank's Board of Directors and the approval of the Farm Credit Administration. *No share of the Bank's Class C stock has ever been sold by a cooperative,* so there is obviously no market in this stock that would aid evaluation.

Additional characteristics of the stock severely limit its value in the hands of the taxpayers. *It pays no dividend and has no growth potential. After the purchase of their initial, qualifying shares, taxpayers gained no voting rights by the purchase of additional Class C stock.* The Bank has a first lien on all Class C shares. While the governing legislation provides that Class C shares may be retired at some date in the future, retirement will be at par ($100) and must await the prior retirement of all Class A stock and all senior Class B shares. Retirement is also subject to the discretion of officials of the bank system. *Until this uncertain retirement date, the shares have no value to taxpayers in the usual sense. The Bank will not accept Class C shares in satisfaction of future "interest override" obligations, nor will it accept Class C shares as collateral for a loan.* These factors, the limited marketability and limited value of the shares themselves, make application of the normal "willing buyer and willing seller" standard, for determining fair market value, unfeasible.

The government appears to concede that these shares have no market value, but urges that they possess an "intrinsic" or "intangible" value in taxpayers' hands which renders their cost a capital investment. First it contends that taxpayers benefit from low cost loans and other Bank services because of the existence of the banking system assured through their continued

purchases of Class C stock. *As has been noted, however, the right to Bank services is established by the purchase of the initial qualifying shares.*

The above quotations from the Courts of Appeal for the Fifth Circuit and the Eighth Circuit and from the Court of Claims are sufficient to demonstrate the entirely different factual situations which existed concerning the value of the entries upon the books of each separate bank for cooperatives.

The United States refers to the twelve regional banks for cooperatives as if they were comparable institutions from the viewpoint of financial worth and in relation to the value of their Class C stock or credits entered as such. We will not burden this Response with quotations of the evidence demonstrating the vast differences in the financial structure of the several banks which support the finding of these three Courts of different values attributable to "entries" or "stock" of similar nature. However, as a demonstration of the difference in the financial worth (and in the value of Class C stock or entries so designated) of the two banks particularly here involved, we point out that in 1956 there was outstanding Class A stock of the St. Louis Bank for Cooperatives in the amount of $10,457,000, and Class B stock in said Bank in the amount of $2,223,200. Both of these stocks are senior to and receive preference over the Class C stock. In 1967 there was no Class A stock outstanding in the St. Louis Bank (all having been theretofore retired) and the amount of Class B stock outstanding had been reduced to $697,900. Contrasted to this situation (we do not have in the record the exact years involved but the financial worth and the value of Class C stock is illustrated by these facts which do appear in the record) the New Orleans Bank for Cooper-

atives had outstanding in 1956 Class A stock in the amount of $6,928,100 and Class B stock in the amount of $360,460. The Class A stock outstanding in 1963 had been reduced to $4,880,000 and the Class B stock outstanding had been increased to $399,562. Necessarily, the status of Class C stock of each of the twelve regional banks for cooperatives stands on its own facts. Values attributable to Class C stock in one bank can have no relationship to the values attributable to similar stock in another bank.

CONCLUSION

In conclusion we submit that there does not exist a conflict between the Court of Appeals for the Eighth Circuit (on the one hand) and the Court of Claims and the Court of Appeals for the Fifth Circuit (on the other hand). The different results were reached upon different factual situations.

We vigorously urge that, if the Court does consider it appropriate to grant the Petition for Writ of Certiorari filed in the case at bar, the suggestion of the Solicitor General, quoted below, should not be followed:

> If the Court grants the petition in *M.F.A. Central Cooperative,* as we urge it should, we suggest that action on the instant petition be deferred pending the outcome of that case, and that this case be disposed of in accordance with the decision in *M.F.A. Central Cooperative.*

It would be unjust and would deny these taxpayers an opportunity to be heard if the matter were presented to this Court by the M.F.A. Central Cooperative, Inc. upon its record and no opportunity whatever were granted to the taxpayers in the case at bar to appear before this

Court and to be heard in accordance with due process of law.

Respectfully submitted,

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APPENDIX A

PENN YAN AGWAY COOPERATIVE, INC.

v.

The UNITED STATES.

No. 56-66.

United States Court of Claims.

Nov. 14, 1969.

Before COWEN, Chief Judge, and LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON and NICHOLS, Judges.

OPINION

PER CURIAM:

This case was referred to Trial Commissioner Ronald A. Hogenson with directions to make findings of fact and recommendation for conclusions of law under the order of reference and Rule 57(a) [since September 1, 1969, Rule 134(h)]. The commissioner has done so in an opinion and report filed on November 20, 1968. Defendant requested the court to adopt the commissioner's findings of fact with the exception of Finding 45 and excepted to his recommended conclusion of law. The case has been submitted to the court on oral argument of counsel and the briefs of the parties. Since the court agrees with the commissioner's opinion, findings and recommended conclusion of law, with slight additions, as hereinafter set forth, it hereby adopts the same as the basis for its judgment in this case. Therefore, plaintiff is entitled to recover and judgment is entered for plaintiff in the sum of $113 plus interest as provided by law.

Commissioner Hogenson's opinion, as modified by the additions of the court, is as follows:

Plaintiff seeks a ruling in this case that in the computation of its federal income tax liability for the taxable year ending June 30, 1959, it is entitled to deduct, as interest under § 163 of the Internal Revenue Code of 1954, or as ordinary and necessary business expense under § 162, the amount by which its payment that year to the Springfield Bank for Coöperatives for 4.07 shares of class C stock of that bank exceeded the fair market value of such stock at that time. Plaintiff paid $100 per share, or $407. The fair market value was $6.90 per share, or $28.08. Thus, the claimed deduction amounts to $378.92. If plaintiff is entitled to the deduction, judgment should be entered for plaintiff in the sum of $113, plus interest as provided by law.

Defendant's position is that the purchase of the 4.07 shares of the class C stock was a capital investment in the Springfield Bank for Cooperatives under §§ 118 and 1221 of the Internal Revenue Code of 1954, that no disposition of such stock has been made by plaintiff, that a deductible expense or loss did not occur, and that plaintiff's petition should be dismissed.

For the reasons hereinafter stated, it is my opinion that plaintiff is entitled to recover.

Plaintiff, a New York corporation, is and was a farmers' purchasing cooperative. Just prior to the commencement of its 1959 fiscal year, plaintiff borrowed $75,000 from the Springfield Bank for Cooperatives, Springfield, Massachusetts. In accordance with the two loan agreements involved, plaintiff executed and delivered to the bank its two promissory notes, each for $37,500, and received from the bank $74,900 in cash and one share of the bank's class C stock of $100 par value. This one share (not part of the 4.07 shares upon which plaintiff's claim

is based) was that required by statute, 12 U.S.C. § 1134d (a) (3), to qualify plaintiff cooperative to borrow from the bank. Obviously, plaintiff had not acquired any of such stock previously.

During its fiscal year 1959, plaintiff was required to purchase from the bank 4.07 additional shares of the bank's class C stock at the par value of $100 per share. This requirement was provided by the cited statute and the terms of the loan agreements, which stated that the borrowing cooperative had to purchase such stock in an amount equal to not less than 10 or more than 25 percent, as prescribed by the board of directors of the bank with the approval of the Farm Credit Administration, of the amount of interest payable by the borrower to the bank for each calendar quarter. For the period of time involved herein, the rate of purchase had been duly fixed at .15 percent. Accordingly, plaintiff during the pertinent fiscal year paid $407 to the bank (being 15 percent of its interest obligations on the pertinent loans during that time) and received 4.07 shares of the bank's class C stock at par value of $100 each.

The 4.07 shares of class C stock are and were carried on plaintiff's financial records in an asset account entitled "Investments—Bank for Cooperatives." In its annual reports to stockholders, the Springfield Bank has consistently described the purchase and ownership of class C stock by its borrowing cooperatives as investment capital.

The Springfield Bank for Cooperatives is one of 12 regional banks, which together with the Central Bank for Cooperatives, comprise a system of banks for cooperatives operated since 1933 under charters issued by the Farm Credit Administration pursuant to statutory authorization.

Prior to the organization of the Farm Credit Administration and the system of banks for cooperatives pursuant to the Farm Credit Act of 1933, 48 Stat. 257, farmers generally as well as farmers' cooperatives had encountered severe difficulties in securing adequate commercial credit at reasonable interest rates. Such problems had not been solved in the administration by the Federal Farm Loan Board of the Federal Farm Loan Act of 1916, 39 Stat. 360, enacted by Congress to provide loans by the Federal land banks on farm mortgage security to farmers and farmers' cooperatives.

To improve and expand the sources of credit at reasonable rates to farmers, and to stimulate the growth and development of farmers' cooperatives, Congress enacted the Farm Credit Act of 1933, *supra*, pursuant to which, the system of banks for cooperatives was established as part of the overall structure of the Farm Credit Administration. This agency in considerably expanded form succeeded to the functions of the previous Federal Farm Loan Board.

The capital of the banks for cooperatives was derived from public funds appropriated by Congress, except that additional capital was supplied pursuant to a provision of the founding act that a borrowing cooperative had to purchase $100 of stock of the lending bank for each $2,000 borrowed. However, such stock was redeemable on demand at the option of the cooperative upon the payment of the outstanding loan.

Defendant's original capital investment, or stock subscription, in the banks for cooperatives as they were established under the Farm Credit Act of 1933, *supra*, amounted to $110,000,000, with $5,000,000 provided to each of the 12 regional banks, and $50,000,000 to the Central Bank for Cooperatives.

In time, the leaders of the system of banks for cooperatives evolved, a plan of retirement of government-owned stock, utilizing the revolving fund method, commonly employed in supplying capital to farmers' cooperatives by its members. In the operation of a farmers' cooperative, usually the members contribute the initial capital, with further contributions being made by each member in succeeding years in proportion to his use of, or benefits received from, the cooperative, and with capital investment being periodically returned to members in order of its contribution.

After a number of years of consideration of such a plan, Congress enacted the Farm Credit Act of 1953, 67 Stat. 390, which established the Federal Farm Credit Board to (a) exercise general direction and supervision over the performance of the system of banks for cooperatives, and to (b) consider and make recommendations to Congress on the best means for eventually retiring the government capital from the Farm Credit System.

Pursuant to the recommendations of the Federal Farm Credit Board, Congress enacted the Farm Credit Act of 1955, 69 Stat. 655, effective January 1, 1956, which provided a comprehensive plan for retirement of government-owned capital from the banks for cooperatives, with the ultimate management, control, and ownership of each bank to become vested in its borrowing cooperatives. The act provided for three classes of stock, each having par value of $100 per share: Class A for government-owned capital; class B to be issued to private investors; and class C to be issued only to farmers' cooperatives borrowing from the particular bank.

Class A stock could be issued only to the Governor of the Farm Credit Administration on behalf of the United

States. It was nonvoting and no dividends could be paid thereon. Each regional bank was required to retire each year an amount of class A stock at least equivalent to the amount of class C stock issued for that year, with some exceptions not of great moment in this case.

As provided by the act, class B stock could be issued at par to any person. It was nonvoting and could pay dividends of not to exceed 4 percent per annum of its par value. It could be called for retirement at par, in the order of its issuance, but only after the retirement of all class A stock.

As provided by the act, class C stock, except upon authorization of the board of directors of the issuing bank and approval of the Farm Credit Administration, could be issued or transferred only to farmers' cooperatives. It could be issued at no more than its $100 par value and could pay no dividends. Each holder of class C stock was entitled to no more than one vote, regardless of the number of shares held.[1] Each borrower from a bank was required to own at the time the loan was made at least one share of class C stock, and was also required to invest quarterly in class C stock an amount equal to not less than 10 nor more than 25 percent, as prescribed by the board of directors of the bank with the approval of the Farm Credit Administration, of the amount of interest payable by it to the bank during the calendar quarter. In the discretion of the board of directors of the bank, class C stock could be retired at par, in the order of its

1. The principle of one vote per shareholder, regardless of the number of shares held, is characteristic of farmers' cooperative organizations, in conformity with the Capper-Volstead Cooperative Marketing Associations Act, 42 Stat. 388, which exempted farmers and their cooperative marketing associations from prosecution for acting in restraint of trade, provided *inter alia* that no member of such a cooperative be allowed more than one vote, regardless of the amount of stock held by him.

issuance. But class C stock issued for any fiscal year could be retired only after all class A stock had been retired, and all class B stock issued during or prior to that fiscal year had been called for retirement. Each regional bank had a first lien on class C stock as collateral for the owner's indebtedness to the bank, and could retire the class C stock of a defaulting borrower, at par, in total or partial liquidation of such indebtedness.

The overall purpose of the act was to accomplish retirement of all class A and B stock, after which the oldest class C stock (in order of its issuance) would be retired, as new class C stock was issued to borrowing cooperatives, and a revolving fund method of capitalization would be fully established. 2 U.S.C.Cong. & Admin.News, p. 2957, 84th Cong., 1st Sess., 1955.

Congress intended that the class C stock would be the voting, common stock of each bank, 2 U.S.C.Cong. & Admin.News, supra, at pp. 2955-2956, and provided in the act that any holder of such stock shall not be entitled to vote, if it has not been a borrower from the bank within the period of two years next preceding a date, fixed by the Farm Credit Administration, prior to the commencement of voting. Since the class A and class B stockholders have no voting rights, the class C stockholders are the only ones with power to elect members to the board of directors of the bank. Prior to 1964, the holders of class C stock of each bank could elect only one of its seven directors, and since 1964, they have elected two of the seven. The other five directors are elected by the local district Production Credit Associations (two members), and the local district Federal Land Bank Associations (two members), with the seventh being appointed by the Governor of the Farm Credit Administration.

The rate of interest charged to plaintiff by the Springfield Bank on the pertinent loan transactions (as stated in the loan documents) was 4.75 percent per annum. This was exclusive of the 15 percent assessment on payable interest for purchase of class C stock. Such assessment could be considered in whole or in part as additional interest by way of a surcharge on the basic interest rate, or as an ordinary and necessary business expense, or as a measurement of the statutory obligation of a borrowing cooperative to invest capital in the lending bank for cooperatives.

The 15 percent surcharge on interest, if the stock purchase assessment be considered that, would increase the basic interest rate of 4.75 percent by 0.7125 to 5.4625 percent per annum. Since plaintiff concedes that 6.9 percent of the cost of each of the pertinent shares of stock (the \$6.90 market value of each share paid for at \$100 par value) was not deductible interest or expense, the surcharge on interest (under plaintiff's theory) would be 93.1 percent of the 15 percent assessment, thus increasing the basic interest rate of 4.75 by 0.6633 to 5.4133 percent per annum.

Since their organization in 1933, the banks for cooperatives have consistently provided lower rates of interest to farmers' cooperatives than could have been obtained on similar loans at commercial banks. For the year 1960 (there being no specific evidence in the record for 1959), the comparative annual interest charges on loans to farm customers were respectively on mortgage and production loans: 4.75 and 5.75 percent by banks for cooperatives, and 6 and 6.9 percent by commercial banks.

It is obvious that even with the addition of the above-described 15 percent surcharge on the basic inter-

est rate of 4.75 percent, plaintiff obtained a lesser rate of interest from the Springfield Bank than it could have obtained from a commercial bank, because plaintiff calculated the comparative cost of borrowing from the Springfield Bank vis-a-vis a commercial bank, and took into consideration that the requirement of purchasing class C stock (to the extent of 15 percent of interest payable on cooperative bank loans) was a loss of use of funds and that such expenditures were an added cost factor over and above the basic rate provided by the Springfield Bank. Furthermore, from the overall policy of the banks for cooperatives, guided by the Farm Credit Administration in expression of the will of Congress, it can be inferred that more favorable interest rates as compared to commercial credit rates have been and will continue to be provided by such banks to farmers' cooperatives, even adding the cost of the required purchase of class C stock on the theory that such cost is an increase of or a surcharge upon the basic interest rates provided by such banks. Plaintiff did not receive any special services other than the lending of money from the Springfield Bank.

As in the case of all the banks for cooperatives, the profits of the Springfield Bank, to the extent they exceeded certain amounts of reserves specified by statute, were required by law to be distributed to borrowers as patronage refunds, in the form of class C stock, not in proportion to the class C stock owned by each borrower, but in the proportion that the amount of interest on the loans of each borrower bore to the total interest earned by the bank on the loans of all borrowers during the fiscal year. This was in accordance with the cooperative principle that those who make use of the cooperative's facilities, and hence, bear the costs of operation, should be able to reduce their costs by receiving a portion of the cooperative's profits allocated on a patronage or use basis.

For its share of the distributed profits of the Springfield Bank for the fiscal year ending June 30, 1959, plaintiff received 9.76 shares of class C stock.

However, except for the right ultimately to receive their par value on redemption, the 4.07 shares of class C stock involved in plaintiff's claim did not entitle plaintiff to any benefit which plaintiff did not already enjoy by reason of having acquired in 1958 the single qualifying share required by law in order to permit it to borrow from the bank. The 4.07 shares gave plaintiff no additional voting rights, no additional right to share in the profits of the bank, and no additional benefits of any kind.

As of December 31, 1955, defendant had $6,600,000 invested in the Springfield Bank for Cooperatives, for which class A stock was issued. From January 1, 1956, the effective date of the act authorizing the three classes of stock, to June 30, 1959, defendant's holding of class A stock was reduced by $875,600 by redemption by the bank of class A stock in that amount. The retirement rate was about $245,000 per year during that period of time. As of June 30, 1959, there was no evidence of any trend toward a larger retirement rate.

As of June 30, 1958, the Springfield Bank had issued and outstanding about $7,800,000 par value of class A, B, and C stock, all of which would have had to be retired before any of the class C stock issued in fiscal year 1959. Thus, plaintiff's 4.07 shares of class C stock acquired in that year would be reached for retirement in 30 to 31 years at the experienced retirement rate of $245,000 per year of the previously issued stock.

Plaintiff now owns and has continued to own the 4.07 shares of class C stock ever since acquired from the Spring-

field Bank in the taxable year involved. There have been no sales of class C stock other than issuance by a bank for cooperatives to a borrowing farmers' cooperative. As stated above, such stock could be issued or transferred only to a farmers' cooperative, except upon authorization of the bank's board of directors with approval of the Farm Credit Administration. There is no evidence that approval could be obtained of a sale to any investor other than a cooperative, and it is not shown that any cooperative would have been willing to buy plaintiff's 4.07 shares at any satisfactory price. Plaintiff reasonably believed that there was no market for such stock.

The fair market value of plaintiff's 4.07 shares of class C stock was established at $6.90 per share as of the time of its acquisition by plaintiff in 1959 by expert stock evaluation testimony adduced by plaintiff. Assuming correctly that no dividends could be paid on such stock, and that no sales had occurred, the experts concluded that the willing buyer would be an investor who would know that he would realize no return upon such stock except its $100 par value upon its retirement in 30 or 31 years, that such an investor, in accordance with historical experience in trading in common stocks, would expect a return (including dividends and appreciation in value) of 9 to 10 percent compounded annually on an investment in common stocks at that time, and that the sales price of $6.90 per share compounded annually at such a rate would amount to the $100 which would be returned to such investor in 30 to 31 years.

Defendant's basic position is that the legislative history and the statutory method of providing capital to the banks for cooperatives by use of the revolving fund principle demonstrate that plaintiff's purchase of the 4.07 shares of class C stock was intended by Congress, the

bank, and plaintiff to be a capital investment, and that such stock is and was a capital asset acquired and held by plaintiff under § 1221 of the Internal Revenue Code of 1954.

Defendant ascribes a full value of $100 per share as of the time of plaintiff's acquisition of such stock on the illusory argument that such value is established by (1) the "extremely valuable intangible benefit" which all member cooperatives (including plaintiff among all others) received from the system of banks for cooperatives, i.e.; the right to borrow large sums of money over long periods of time at low interest rates, as contrasted with rates available at commercial banks; (2) the alleged impossibility of assigning a "determinable market value" to such stock because of its special characteristics; and (3) the fairness for tax purposes of awaiting the realization of the $100 per share proceeds of redemption, since plaintiff's method of valuation was a "discounting of the redemption value" to $6.90 per share "based upon a speculation as to when it would be redeemed and a hypothetical discount factor derived from other unrelated investments."

But the cold fact remains that when plaintiff paid the $407 for the 4.07 shares, it received stock which was greatly less valuable from an economic and financial standpoint than the purchase price required by law and the terms of the loan agreements. The "intangible benefits" bestowed by Congress on farmers' cooperatives generally do not alter this fact. As reasonable management of the business would be expected to do, plaintiff considered the long delay in recovery of the purchase price of such no-dividend stock as a loss of use of funds in calculating the comparative loan costs from the Springfield Bank vis-a-vis a commercial bank. The required purchase of such stock gave plaintiff no economic or financial benefit other

than the circumstance that it could not have obtained the loan with its favorable interest rate without fulfillment of the statutory requirement. But in the extremely practical field of taxation, in which substance prevails over form, it cannot reasonably be concluded under the circumstances that Congress has granted favors to cooperatives in furtherance of agricultural policies and taken them away (on the theory of intangible benefits) in whole or in part in the field of raising of public revenues. It is obvious under the facts of this case that plaintiff did not consider, nor could it reasonably be held to have considered, that its required payment of $407 for such stock, was an investment, as no return on such purported investment could be realized, except repayment of the bare purchase price delayed for many years.

Of course, Congress considered the 15 percent surcharge on interest payable on loans as a means of providing capital to the banks for cooperatives, and the bank realistically and lawfully treated as capital, funds received in that manner. But from the standpoint of plaintiff-taxpayer, this was in reality an increase of the basic interest rate as an experienced cost of borrowing money from the bank, even described in the statute and in the loan agreements as a percentage of interest payable on the loans. Its expenditure of $407, at least in greater part, was in reality an item of cost of conducting its business, and in the absence of compelling law to the contrary, and to the extent that it was a reasonably ascertainable cost, should be offset against plaintiff's income in the taxable year involved, in accordance with the annual accounting principle of the federal income tax laws. This is true whether such ascertainable cost is deemed interest paid under § 163 or an ordinary and necessary business expense under § 162 of the Internal Revenue Code of 1954.

[1, 2] It is a well established rule of law, carefully analyzed and stated in Drybrough v. United States, 208 F.Supp. 279 (W.D. Ky. 1962), that the market value of common stock in a closely held corporation, there being no market sales of such stock, must be determined upon consideration of all relevant factors, such as earning capacity, anticipated profits, book value, and dividend yield. Obviously, the relevant factors concerning the value of plaintiff's 4.07 shares of class C stock are extremely limited. The only right they carry and have carried is long-delayed redemption at their bare purchase price. But the difficulties inherent in determining their fair market value should not be permitted to defeat a fair and just decision in this case, and consequently plaintiff's evaluation of its 4.07 shares is accepted as the most an investor (which apparently would have to be another farmers' cooperative) would pay, if such a purchaser could be found. Defendant did not offer any evidence to the effect that plaintiff's experts used a discount rate which was more than reasonable, and its expert testimony was that the pertinent stock had a value of $100 per share, unsupported unless defendant's theory of intangible benefits be sustained.

Of course, plaintiff had a right to participate in a division of the assets of the Springfield Bank in the event of its dissolution and liquidation prior to the redemption of plaintiff's stock. But such an event is and was extremely unlikely for various obvious reasons, including unlikely abandonment by Congress of firmly established agricultural policy and the fact that the Springfield Bank and the other banks for cooperatives were jointly and severally liable on $284,500,000 of consolidated debentures issued by such banks. Furthermore, each of such banks has powerful safeguards against financial difficulty

by delaying without cost (in the exercise of their statutory discretion) the redemption of class C stock, by increasing within the statutory limits the required purchase of new class C stock up to 25 percent of interest payable on new loans, and by increasing the basic interest rate on new loans, in line with any increases in commercial credit rates, all without being required to distribute any dividends (other than class C stock) to its stockholders, and then only on a patronage or use basis.

Defendant stresses the fact that plaintiff has continued to own the 4.07 shares of stock ever since acquired from the bank, and argues that this fact distinguishes this case from various cases relied upon by plaintiff. Defendant's position is that even if it is decided that plaintiff acquired the stock when it had a value of $6.90 per share, at a price of $100 per share, such a bad bargain does not give rise to a deductible loss or business expense, but the tax consequences must await the disposition of such assets. Defendant relies upon Montana Power Co. v. United States, 159 F.Supp. 593, 595, 141 Ct.Cl. 620, 623-624, cert. denied, 358 U.S. 842, 79 S.Ct. 23, 3 L.Ed. 2d 76 (1958); Booth Newspapers, Inc. v. United States, 303 F.2d 916, 922, 157 Ct.Cl. 886, 896-897 (1962); Chase Candy Co. v. United States, 126 F.Supp. 521, 130 Ct.Cl. 102 (1954); Koppers Co., Inc. v. United States, 278 F.2d 946, 949, 150 Ct.Cl. 556, 560 (1960). But defendant's interpretation of such cases, whether such a holding be expressed or implied therein, cannot reasonably be applied under the facts of the instant case. In my opinion, it would be unfair and unjust to apply such a doctrine in the circumstances where disposition by plaintiff of the class C stock was a practical impossibility due to lack of a market, which resulted from the statutory restrictions placed upon such stock under the capitalization formula prescribed by law for the banks for cooperatives.

A bonus or premium paid by a taxpayer to induce a loan has been held to be deductible as interest within the meaning of the pertinent section of the federal income tax statutes. Wiggin Terminals, Inc. v. United States, 36 F.2d 893 (1st Cir. 1929) (Payment of $50,000 cash bonus); L-R Heat Treating Co., 28 T.C. 894 (1957) ($61,200 withheld from amounts paid to borrower as premiums for making loans); Court Holding Co. v. Commissioner, 2 T.C. 531, 536 (1943), rev'd on other grounds, 143 F.2d 823 (5th Cir. 1944), circuit court rev'd and tax court aff'd on the other grounds, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 567 (1945) (Payment of $350 cash bonus). In each of these cases, the borrower in effect parted with additional money, over and above the agreed interest rate, and for such additional payments, received nothing in return other than the use of the lender's money.

In *Wiggin, supra,* the payment of the bonus over and above the agreed interest rate was accomplished by the borrower issuing stock to the lender for a temporary period and paying dividends thereon equal to the bonus agreed upon, but the court held that it made no difference what the reason was for paying in that form, and ruled that the real character of the payment of the dividends was interest, according to the intent of the parties.

Universally accepted in cases involving the applicability of usury laws is the general principle, stated in Oil City Motor Co. v. C.I.T. Corp., 76 F.2d 589, 591, 104 A.L.R. 240 (10th Cir. 1935), and in Memorial Gardens of Wasatch, Inc. v. Everett Vinson & Associates, 264 F.2d 282, 285 (10th Cir. 1959), as follows:

> * * * The familiar doctrine is invoked that if as a condition to the making of a loan at an apparently permissible rate of interest, the lender requires the borrower to sell property to him at less than its value

> or to purchase property from him at an excessive price, the difference represents interest and will be taken into account in determining whether the transaction is usurious. * * *

In the application of this rule, it would seem clear that if the lender required the borrower to purchase common stocks at a price greater than its market value, as a part of the loan transaction, the excess of the price over the market value would be deemed interest in the case involving usury laws.

Plaintiff relies heavily upon Ancel Greene & Co., 38 T.C. 125 (1962), asserting that it is "square authority for the deduction claimed by plaintiff" herein; and also upon McMillan Mortgage Co., 36 T.C. 924 (1961).

In *Ancel Greene*, taxpayer was engaged in buying, selling, and servicing real estate mortgages, and sold mortgages to the Federal National Mortgage Association (FNMA), created by Congress and operating with government-owned capital, as a secondary market facility for home mortgages. By statute, 12 U.S.C. § 1718(a) and (b), FNMA was required to accumulate funds for its capital surplus account from private sources by requiring each mortgage seller to make payments of nonrefundable capital contributions, measured by a percentage of the unpaid principal amounts of mortgages purchased, and to issue its common stock for such contributions. In each of the mortgage sales agreements, reached in each of the three successive taxable years in suit, taxpayer subscribed to such stock, and agreed to have FNMA deduct from the sales price for the mortgages the purchase price of the stock, i. e., its par value of $100 per share. Such stock was actively traded, and during the taxable years in suit had a market value varying from $40.50 to $63 per share. In computing taxable income, taxpayer deducted as ordi-

nary and necessary expense of doing business, the difference between the amount paid to FNMA for such stock and the market value thereof. Such deductions having been disallowed by the Internal Revenue Service, the issue as stated by the court was whether any portion of the purchase price of the stock, withheld by FNMA from the sales price of the mortgages, is *not includible* or is *deductible* from taxpayer's income. Holding for taxpayer and against Internal Revenue that the sale of mortgages and the purchase of the FNMA stock constituted a single and inseparable transaction, the court concluded that the taxpayer was required to include in income, receipts from the mortgages sold to FNMA plus the fair market value of the FNMA stock. In effect, the court answered the issue as stated, by allowing as a deduction that which had been claimed in the taxpayer's returns, i. e., the difference between the amount paid to FNMA for such stock and its fair market value at the time. The court thus rejected the position of Internal Revenue that the pertinent stock was a capital asset with a cost basis of $100 per share, at least to the extent to which its cost exceeded its fair market value.

Contrary to any of the language used by the court, defendant construes the holding of the court in *Ancel Greene* to amount to the allowance of an ordinary loss on the sales of the mortgages.

The court further found in *Ancel Greene* that taxpayer held substantial portions of the stock for periods in excess of a year and a half and at the end of the last fiscal year in suit was still holding some stock which had been held by it for over 2½ years.[2] As in the instant case,

2. It is obvious that the tax court allowed deductions from income with respect to FNMA stock which the taxpayer purchased during but still held after the taxable years in suit, and thus impliedly held that the tax treatment accorded was not dependent upon a sale or exchange of such stock by the taxpayer.

taxpayer carried the pertinent stock in an investment account in its financial records. In the absence of any other evidence, the court assumed that taxpayer held such stock as an investment either for receipt of dividends payable thereon or in the hope that the market price would increase. On the second issue in the case, the court held that the shares of FNMA stock were capital assets when sold by taxpayer, ruling, however, that gain or loss upon such sales was to be computed by using as the basis for each share of stock sold, the fair market value of such share at the date of its issuance to taxpayer.

Also in *Ancel Greene,* the tax court correctly commented that the facts with respect to acquisition of FNMA stock were identical except as to amounts and dates with those in *McMillan Co., supra,* but that the facts with respect to the carrying and holding of the stock differed in the two cases. In *McMillan Co.,* the FNMA stock was held by the taxpayer for relatively short periods of time, when a market existed for such stock, and with no intent to hold such stock as an investment.

In the instant case, the class C stock has been held by plaintiff for a substantial period of time, when no market existed, with no intent to hold such stock as an investment.

In *McMillan Co., supra,* the facts were identical with those in *Ancel Greene,* except that the taxpayer did not treat its FNMA stock holdings on its books and records as investments or capital assets, but rather as current assets, recording gain or loss on its sales of such stock as ordinary gain or loss. Furthermore, all shares of such stock were sold or otherwise disposed of within 6 months after their acquisition, with a large number within 60 days. Taxpayer in its contested tax returns treated its

dispositions of the stock as ordinary gains or losses, with deficiencies assessed by the Internal Revenue Service on the theory that taxpayer's FNMA stock acquisitions were not purchases of inventory items but of capital assets; that the basis of such stock was its cost of $100 per share, irrespective of its fair market value; and that gain or loss upon subsequent disposition of such stock constituted a capital gain or loss, and not a deductible business expense. The court stated the issue to be whether such shares of stock were capital assets in the hands of the taxpayer, and sustained taxpayer's position that the FNMA stock in its hands was within the first exclusion from the definition of a capital asset contained in § 1221 of the Internal Revenue Code of 1954, as follows:

> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

The court reasoned that in the conduct of its business the taxpayer first resorted to the private investors' market, but when funds were not available there, turned to the secondary market (FNMA) provided by law for just such purpose, that the FNMA transactions were entered into in the ordinary course of taxpayer's business of marketing its mortgages, that as an integral and essential part of dealing with FNMA, it was required to take part of the proceeds of sale of mortgages to FNMA in FNMA stock at par value, and that it held such stock for sale in the conduct of its business, as shown by its prompt sales thereof, and also by the fact that it would have been unreasonable for taxpayer to have kept funds tied up in such stock when presumably it was the need for liquidity which compelled the sale to FNMA under less favorable terms

than in the primary market. The court held that taxpayer's acquisition of such stock and its sale was a normal business activity incident to taxpayer's business, that such stock was not a capital asset, and that taxpayer's "expenditures (whether considered to be expenditures of cash or expenditures of part of the agreed price of mortgages) were necessary expenditures of the business and hence the amount was a deductible item."[3] 36 T.C. at 933.

In M.F.A. Central Cooperative v. Bookwalter, 286 F. Supp. 956 (E.D.Mo.June 14, 1968), now on appeal to the Eighth Circuit Court of Appeals, the district court held that the class C stock, required to be purchased by taxpayer cooperative from the St. Louis Bank for Cooperatives in an amount equal to 15 percent of interest payable by such cooperative to the bank on its outstanding loans, did not have any fair market value at the time of its issue, that the purchase price paid for such stock was not interest, but that such price was deductible as ordinary and necessary business expense.

On the interest issue, the district court distinguished the above-cited *Wiggin Terminals, L—R Heat Treating,* and *Court Holding* cases on the grounds that in such cases, the debtor parted with additional money in the

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3. In Section 8 of Public Law No. 86-779, 86th Cong., 2d Sess., September 14, 1960, 1960-2 Cum.Bull. 709, 713, Congress added § 162(d) to the Internal Revenue Code of 1954, effective for taxable years beginning after 1959, which specifically provides that whenever the amount of required capital contributions to FNMA exceeds the fair market value of the FNMA stock as of its issue date, the purchaser of such stock shall treat the excess as deductible ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. The Committee reports expressly stated that "Viewed fom such a taxpayer's standpoint, the excess appears clearly to be expenditures which he must incur in order to sell the mortgage paper he holds." H.R.Rep.No. 1662, 86th Cong.2d Sess. 3 (1960), 1960-2 C.B. 816, 818; S.Rep.No. 1767, 86th Cong.2d Sess. 8 (1960), 1960-2 C.B. 829, 834. This legislative characterization precisely fits the situation in the instant case.

form of a bonus or premium and received nothing in return other than use of the lender's money, whereas in the case under consideration, *M.F.A. Central Cooperative* received class C stock for the additional money.

In support of its decision that the purchase price of such stock was an ordinary and necessary business expense, the district court analyzed the facts and circumstances involved, and concluded that the class C stock was of absolutely no use or benefit to the taxpayer, and that the only reason it was purchased was because taxpayer wanted to borrow money from the bank for cooperatives, and the agreement to purchase such stock was imposed as a condition of the loan.

While there is considerable merit in the district court's reliance on the theory of deductible expense, it is my opinion that the more logical basis for allowance of the claimed deduction in this case under all of the facts and circumstances is that the purchase price of the class C stock (to the extent that such price exceeded the market value of such stock, as such value is conceded by plaintiff) was interest paid and deductible under § 163 of the Internal Revenue Code of 1954, particularly because the amount of such stock required to be purchased by law and by the loan agreements involved was measured by a percentage of the interest payable on plaintiff's outstanding loan obligations to the bank issuing the stock. It is held that plaintiff's claimed deduction is allowable as interest paid.[4]

4. Mississippi Chemical Corp. v. United States, S.D.Miss. decided February 14, 1969, 69-1 U.S.T.C., par. 9266, now on appeal to the Court of Appeals for the Fifth Circuit, has recently held the same deduction allowable as interest.

APPENDIX B

In the United States Court of Appeals
for the Fifth Circuit

No. 28271

MISSISSIPPI CHEMICAL CORPORATION,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

COASTAL CHEMICAL CORPORATION, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeals from the United States District Court for the Southern District of Mississippi

(September 14, 1970)

BEFORE GEWIN, GODBOLD and CLARK, Circuit Judges.

GEWIN, Circuit Judge: The government appeals from separate judgments entered for Mississippi Chemical Corporation and Coastal Chemical Corporation (hereinafter, taxpayers) in their suits for refund of federal taxes. Taxpayers based their claims for refund on the contention that $99 of each $100 expended for the purchase of certain Class C stock in the New Orleans Bank for Cooperatives constituted deductible expenses in the year of purchase. The government contended that these amounts were the

non-deductible costs of acquiring capital assets. The district court concluded that the payments were deductible as interest expenses, and we affirm.

Taxpayers are Mississippi corporations with their principal place of business in Yazoo City, Mississippi. During the tax years in question they were "cooperative associations" as defined in the Agricultural Marketing Act.[1] Taxpayers are stockholders in, and borrowers from, the New Orleans Bank for Cooperatives (hereinafter, the Bank). The Bank is part of a banking system created by the federal government[2] during the depression to provide low cost loans to farmer's marketing, purchasing, and service cooperatives. It is one of the twelve regional banks in the system and serves Louisiana, Mississippi, and Alabama.

The governing legislation[3] provides for three classes of stock in a regional bank. Class A stock represents the original capital contributed by the United States. These shares are non-voting and pay no dividend. The legislation contains a scheme of retirement for Class A shares which is dependent on the amount of Class C stock purchased and on the net profits of the regional bank. Class B stock may be issued to any person. It is non-voting but may bear a dividend not to exceed four percent per annum. Class C stock may only be issued to banks for cooperatives and to farmers' cooperative associations. It pays no dividend. Each holder of Class C stock is entitled to one vote, though a cooperative has only the single vote regardless of the number of Class C shares held.

Farmers cooperatives, like taxpayers, acquire Class C shares in three ways: (1) Each cooperative must pur-

1. 12 U.S.C. § 1141(j).
2. 12 U.S.C. § 1134.
3. 12 U.S.C. § 1134(d).

chase a qualifying share of Class C stock to be eligible to borrow from the Bank. (2) A borrower cooperative is required to make quarterly investments in Class C stock; these purchases are referred to as "interest override" payments. The amount required to be invested is not less than ten nor more than twenty-five percent of the interest payable by the borrower for that quarter, to be determined by the Bank's directors.[4] (3) Class C stock is also received by farmer's cooperatives as a distribution of the Bank's net profits during a fiscal year. These distributions, called "patronage refunds", are computed in amount "in the proportion that the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the fiscal year."[5]

Mississippi Chemical Corporation acquired its qualifying share of Class C stock in 1956; Coastal Chemical Corporation purchased its share in 1957. Each carried its initial share on its books at the $100 cost, and neither sought a deduction for any part of this expense. These qualifying shares were not involved in the suit below.

Mississippi Chemical's suit concerned the fiscal years ending 30 June 1961, 1962, and 1963. As a result of its borrowings during those years it was required to make "interest override" purchases of 189, 169, and 193 shares of Class C stock respectively. The purchase price of each share of stock was $100. In its tax returns for each year, Mississippi Chemical reported $1 per share as the cost of acquiring a capital asset and claimed a deduction in the amount of $99 a share as an interest expense. In the same fiscal years, Mississippi Chemical received "patronage refunds" of 287, 275, and 251 shares of Class C stock re-

4. The rate for the New Orleans Bank during the periods in question was 15%.

5. 12 U.S.C. § 1134(1)(b).

spectively. It reported $1 per share of the "patronage refund" as a reduction of interest expense and investments, but it made no report of the remaining $99 of par value of each share.

Coastal Chemical's suit involved a longer period of time including the fiscal years ending 30 June 1958 through 1963. In these years Coastal Chemical purchased 118, 339, 473, 417, 351, and 421 shares of Class C stock respectively pursuant to the "interest override" requirements. During the same years, it received 143, 474, 516, 605, 523, and 630 shares of Class C stock as "patronage refunds." In its tax returns for these periods, Coastal Chemical treated the shares purchased and those received as "patronage dividends" in the same manner as Mississippi Chemical.

The Commissioner disallowed the interest deduction claimed by each taxpayer and asserted deficiencies. Taxpayers paid the deficiencies and filed claims for refund which were disallowed. Taxpayers then instituted their actions which were consolidated for trial in the district court. The court below upheld the taxpayer's contention that $99 of each $100 expended for the purchase of a share of Class C stock was deductible as an interest expense. In the district court the government also contended that taxpayers should have reported the Class C stock received as patronage refunds as income. The court did not sustain this position and it has been abandoned by the government.[6] As a result the present appeal is concerned solely

6. In a footnote to its brief the government states:

"The Government also contended in the lower court, that the taxpayers should have reported the patronage dividends (refunds) of shares of Class C stock during the taxable periods in issue as income. The lower court refused to sustain that contention. The Government has not appealed from that part of the judgment."

with the tax treatment of the Class C stock purchased under the "interest override" requirements of 12 U.S.C. § 1134(d)(3)[7]

I

Central to the district court's decision was its finding that the Class C stock,[8] while not worthless, was without any appreciable market value and had at most a nominal value. This conclusion is attributable to the peculiar nature of these shares. Taxpayers could only sell or transfer Class C stock to another qualified farmers' cooperative with the authorization of the Bank's Board of Directors and the approval of the Farm Credit Administration. No share of the Bank's Class C stock has ever

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In this connection the following argument is advanced by amicus curiae:

> "By failing to appeal from the decision below that Class "C" stock received as patronage refunds must be included in plaintiffs' income only to the extent of $1 per share, the government in effect concedes that the fair market value of such stock is no more than $1 per share. Clearly the same standard must apply in assessing the value of the identical stock which is purchased pursuant to the requirements of a loan agreement."

See Commissioner v. *B. A. Carpenter*, 219 F. 2d 635 (5th Cir. 1955); *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (4th Cir. 1957); Treas. Reg. § 1.61-5(b)(1)(iv) (1959).

7. The same question has been involved in two recent cases. In *Penn Yan Agway Cooperative, Inc.* v. *United States*, 417 F. 2d 1372 (Ct.Cl. 1969), the Court of Claims held that amounts paid for Class C shares of the Springfield Bank for Cooperatives under the "interest override" requirements were currently deductible as interest. In *M.F.A. Central Cooperative* v. *Bookwalter*, 286 F. Supp. 956 (E.D. Mo. 1968), the district court allowed current deduction of the cost of Class C shares in the St. Louis Bank for Cooperatives, but considered it an ordinary and necessary business expense rather than interest. On appeal the Eighth Circuit reversed the district court and held that the cost of Class C shares was not currently deductible. *M.F.A. Central Cooperative* v. *Brookwalter*, F. 2d (8th Cir. 1970) [Nos. 19,527—19,531, June 8, 1970].

8. The New Orleans Bank does not issue certificates for the Class C shares. Thus, Class C shares are really only credits entered on the books of the bank in units of $100 and fractional parts thereof.

been sold by a cooperative,[9] so there is obviously no market in this stock that would aid evaluation.

Additional characteristics of the stock severely limit its value in the hands of the taxpayers. It pays no dividend and has no growth potential. After the purchase of their initial, qualifying shares, taxpayers gained no voting rights by the purchase of additional Class C stock. The Bank has a first lien on all Class C shares.[10] While the governing legislation provides that Class C shares may be retired at some date in the future, retirement will be at par (\$100) and must await the prior retirement of all Class A stock and all senior Class B shares. Retirement is also subject to the discretion of officials of the bank system. Until this uncertain retirement date,[11] the shares have no value to taxpayers in the usual sense. The Bank will not accept Class C shares in satisfaction of future "interest override" obligations, nor will it accept Class C shares as collateral for a loan. These factors, the limited marketability and limited value of the shares themselves, make application of the normal "willing buyer and willing seller" standard, for determining fair market value,[12] unfeasible.

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9. The Bank's Class C shares have changed hands only at the liquidation of a cooperative or its merger with another.

10. 12 U.S.C. § 1134(d)(c).

11. For purpose of valuation, the *Penn Yan* court accepted 30 or 31 years as the period required before the stock would be retired based on the history of the Springfield Bank. It is not clear to what extent this figure reflected the discretion of the bank officials or other factors which could operate to defeat or prolong recovery.

12. [Fair market value] is the price at which property will change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts.

Willow Terrace Dev. Co. v. *Commissioner*, 345 F. 2d 933, 936 (5th Cir. 1965).

The government appears to concede that these shares have no market value,[13] but urges that they possess an "intrinsic" or "intangible" value in taxpayers' hands which renders their cost a capital investment. First, it contends that taxpayers benefit from low cost loans and other Bank services because of the existence of the banking system assured through their continued purchases of Class C stock. As has been noted, however, the right to Bank services is established by the purchase of the initial qualifying shares. The government also points to the history of the Banks for Cooperatives[14] which evidences a Congressional intention ultimately to withdraw all government investment from the system. This is to be accomplished by the retirement of Class A stock as the federal investment it represents is replaced by Class C investment through purchases by cooperatives and receipt by them of "patronage refunds." The government urges that when all Class A stock has been retired, the revolving fund method of capitalization, common to cooperative financing, will prevail and the participating cooperatives will be the sole owners of a valuable financial institution. It should be noted that ownership here is not synonymous with control:

> Prior to 1964, the holders of Class C stock of each [regional] bank could elect only one of its seven directors, and since 1964, they have elected two of the seven. The other five directors are elected by the local dis-

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13. The Government states in its brief:

"In truth, because of the special characteristics of the stock there is no reasonable and determinable market value which can be assigned to it. As one authority puts it [Packel, Law of Cooperatives (3d ed.), Sec. 45(d) at 234.]: The circumstances surrounding the issuance of revolving fund certificates are often such that no particular market value can be ascribed to the certificate even though it refers to a sum certain."

14. The history, organization, and capital structure of the Banks for Cooperatives is discussed by the court in *Penn Yan*, 417 F. 2d at 1373-1376.

trict Production Credit Associations (two members), and the local district Federal Land Bank Associations (two members), with the seventh being appointed by the Governor of the Farm Credit Administration.[15]

With their share of control in the Bank thus limited, the fact that Class C shareholders were having capital they supplied substituted for that previously furnished by the government can scarcely be seen as enhancing the value of their shares. In *Penn Yan Agway Cooperative, Inc.* v. *United States*,[16] the Court of Claims rejected the same government argument—that the Class C shares possessed intangible value. The court stated:

> [T]he cold fact remains that when plaintiff cooperative shareholder paid the $407 for the 4.7 shares, it received stock which was greatly less valuable from an economic and financial standpoint than the purchase price required by law and the terms of the loan agreements. The "intangible benefits" bestowed by Congress on farmers' cooperatives generally do not alter this fact . . . The required purchase of such stock gave plaintiff no economic or financial benefit other than the circumstance that it could not have obtained the loan with its favorable interest rate without fulfillment of the statutory requirement. But in the extremely practical field of taxation, in which substance prevails over form, it cannot reasonably be concluded under the circumstances that Congress has granted favors to cooperatives in furtherance of agricultural policies and taken them away (on the theory of intangible benefits) in whole or part in the field of raising of public revenues. It is obvious under the facts of this case that plaintiff did not consider, nor could it reasonably be held to have considered, that its required payment of $407 for such stock, was an investment, as no return on such purported investment

15. *Penn Yan Agway Cooperative, Inc.* v. *United States*, 417 F. 2d 1372, 1375 (Ct. Cl. 1969).

16. 417 F. 2d 1372 (Ct. Cl. 1959).

could be realized, except repayment of the bare purchase price delayed for many years.[17]

In *Penn Yan,* the cooperative shareholder assigned a value of $6.90 to its Class C shares and introduced expert testimony tending to support this general figure as a reasonable estimate of the shares' fair market value. The Court of Claims approved the cooperative's evaluation. In *M.F.A. Central Cooperative* v. *Bookwalter,*[18] the district court concluded that Class C shares in the St. Louis Bank for Cooperatives had no fair market value at all. This conclusion was reversed by the Eighth Circuit which stated, "While the Class C stock has no established market value, it has a substantial book value and while it is likely not worth its par value at the time it is issued, it certainly has substantial value."[19] It should be noted that there is a considerable difference, as to the factors affecting value, between the shares of the St. Louis bank and those involved here.[20] In the present case, considering the nature of the Class C stock and the testimony as to its value adduced in the district court, that court was not clearly erroneous in determining that the Class C shares had no fair market value and no more than a nominal value to the taxpayers.[21]

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17. *Id.* at 1377-1378.

18. 286 F. Supp. 956 (E.D. Mo. 1968).

19. *M.F.A. Central Cooperative* v. *Bookwalter,* F. 2d (8th Cir. 1970) [Nos. 19,527-19,531, June 8, 1970].

20. From statements contained in briefs filed in this court, it appears that by June 30, 1967 the St. Louis Bank had completely retired its Class A shares and substantially reduced the amount of Class B investment. As a consequence it was able to redeem all Class C shares issued during the fiscal year ending June 30, 1956. The M.F.A. Cooperative had purchased St. Louis Class C shares from other cooperatives, and it appears that transactions between cooperatives were not uncommon.

21. Rule 52(a) Fed. R. Civ. Pro.

II

Notwithstanding the absence of a fair market value for the Class C shares, the government contends that taxpayers were not entitled to deduct any portion of their purchase price. It cites *Montana Power Co.* v. *United States,*[22] contending:

> If one buys something and pays more than it is worth, and more than he can resell it for, there are no immediate tax consequences of this everyday occurrence. . . . He must "realize" his bad bargain, his loss, by selling.

We do not dispute the soundness of this tax principle, but consider it inapplicable to the present case.[23] The government advanced the same argument in the *Penn Yan case.* The Court of Claims rejected it stating:

> [I]t would be unfair to apply such a doctrine in the circumstances where disposition by the plaintiff of the class C stock was a practical impossibility due to lack of a market, which resulted from the statutory restrictions placed upon such stock under the capitalization formula prescribed by law for the banks for cooperatives.[24]

Montana Power and the other cases relied on by the government are readily distinguished from the present situation. Taxpayers in the instant case have not been the victims of a bad bargain in the traditional sense;[25] they were required to make continued purchases of Class C

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22. 159 F. Supp. 593, 595 (Ct. Cl.), *cert. denied*, 358 U.S. 842 (1963).

23. *See* Ancel Green & Co., 38 T.C. 125 (1962); McMillian Mortgage Co., 36 T.C. 924 (1961). These cases are thoroughly discussed in *Penn Yan,* 417 F. 2d at 1380-1381.

24. 417 F. 2d at 1379.

25. *See Montana Power Co.* v. *United States*, 159 F. Supp. 593 (Ct. Cl. 1958).

stock in order to secure loans from the Bank. Neither did taxpayers acquire an asset of continuing value, though less than the purchase price;[26] the Class C shares were of no appreciable value to the taxpayers. It is at odds with the incisive realism required in determining the tax consequences of ambiguous transactions to treat these purchases as "investments"; they were something else.[27]

We agree with the trial court and with the Court of Claims in *Penn Yan*, that the purchase price of the Class C stock (in excess of the nominal value assigned it by taxpayers) is deductible as interest in the year of purchase. Section 163(a) of the Code[28] provides, "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." The interest which is deductible under this section is defined as, "the amount one has contracted to pay for the use of borrowed money."[29] As we have noted the Class C stock was without practical value to the taxpayers. Their only reason for acquiring the shares was as a prerequisite for continued borrowing from the Bank. It was in effect a bonus or premium paid in addition to the usual interest, and comes within the

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26. *See Dresser* v. *United States*, 55 F. 2d 499, 512 (Ct. Cl.), *cert. denied* 287 U.S. 635 (1932); *Koppers Co.* v. *United States*, 278 F. 2d 946, 949 (Ct. Cl. 1960).

27. Our decision on this point appears to be at odds with that of the Eighth Circuit in *M.F.A. Central Cooperative* v. *Bookwalter*, ___ F. 2d ___ (8th Cir. 1970) [Nos. 19,527-19,531, June 8, 1970]. Insofar as that court's decision is not attributable to the difference in value of the St. Louis shares, we are simply unable to agree. If we concluded, as did the Eighth Circuit, that the "interest override" payments were made to acquire Class C shares as capital assets, we would agree that recognition of gain or loss must ordinarily await realization through sale or exchange. However, we agree with the court below that, for tax purposes, the bulk of these payments were not *actually* made to acquire an asset.

28. 26 U.S.C. § 163(a).

29. *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 560 (1932).

meaning of interest under 163(a).[30] The *Penn Yan* court supported its similar decision with the proposition borrowed from usury cases that:

> [I]f as a condition to the making of a loan at an apparently permissible rate of interest, the lender requires the borrower to sell property to him at less than its value or to purchase property from him at an excessive price, the difference represents interest. . .[31]

In M.F.A., the district court held that the amounts paid by the plaintiff cooperative for Class C shares of the St. Louis Bank for Cooperatives were not deductible as interest under § 163(a),[32] but allowed a current deduction as an ordinary and necessary business expense under § 162(a).[33] The district court distinguished the cases allowing interest deductions for amounts paid as a bonus or premium to induce a loan,[34] since the debtors in those cases received nothing in return for the bonus but the use of the loaned money while the M.F.A. Cooperative had received Class C stock. Because, of the peculiar nature of the Class C shares, we find this distinction unacceptable. As the district court itself observed:

> This Classic C stock purchased quarterly was of absolutely no use or benefit to M.F.A. Central Coopera-

30. *Wiggin Terminals, Inc.* v. *United States*, 36 F. 2d 893 (1st Cir. 1929); L-R Heat Treating Co., 28 T.C. 894 (1957); Court Holding Co., 2 T.C. 531, 536 (1943), *rev'd on other grounds*, 143 F. 2d 823 (5th Cir. 1944), court of appeals *rev'd* and tax court *aff'd* on other grounds, 324 U.S. 331 (1945). These cases are offered for the same proposition by the Court of Claims in *Penn Yan*, 417 F.2d at 1379.

31. 417 F. 2d at 1379; quoting, *Memorial Gardens* v. *Everett Vinson & Assoc.*, 264 F. 2d 282, 285 (10th Cir. 1959).

32. While the Eighth Circuit reversed the district court insofar as it allowed a deduction as a business expense, it adopted the district court's opinion on the question of interest. *M.F.A. Central Cooperative* v. *Bookwalter*, F. 2d (8th Cir. 1970) [Nos. 19,527-19,531, June 8, 1970].

33. 26 U.S.C. § 162(a).

34. See note 30 *supra*.

tive. . . . The only reason it was purchased was because M.F.A. Central wanted to borrow money from the St. Louis Bank for Cooperatives and the agreement to purchase Class C stock was imposed as a condition of the loan. It is impossible to separate the loan from the purchase of the stock. One was the motivation for the other.[35]

The district court in *M.F.A.* also considered the loan agreement as significant evidence that the parties understood the obligations to purchase the Class C stock to be apart from the interest requirements. We do not feel that the attitude of the parties is controlling. We agree with the Court of Claims in *Penn Yan* that a current deduction was proper and that the appropriate deduction lies under § 163(a).[36] As that court noted this is more logical than the § 162(a) treatment initially given the expenses by the district court in *M.F.A.*, "particularly because the amount of such stock required to be purchased by law and by the loan agreements involved was measured by a percentage of the interest payable on plaintiff's outstanding loan obligations to the bank issuing the stock."[37]

Accordingly, the judgment of the district court is AFFIRMED.

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35. 286 F. Supp. at 961.

36. The quid pro quo for taxpayer's present deduction for an interest expense will arise when and if the Class C shares are redeemed. In that event taxpayers must take $99 into ordinary income. J. Chommie, Federal Income Tax § 17 at 33 (1968); 1 J. Mertens, Federal Income Tax § 7.34 et seq. (1969).

37. 417 F. 2d at 1382.

GODBOLD, Circuit Judge, dissenting:

The majority opinion is a demonstration of what one of the few authorities on the law of cooperatives has counselled against:

> The entire field of cooperative corporation law is so relatively new, the basic principles of the cooperative plan are so fundamentally different from those of corporations for profit, and the temporary or interim character of the capital required for proper functioning of a cooperative is so different from the permanent share capital of other business corporations, that even well established concepts in the field of business corporation law cannot safely be applied to cooperative corporations without careful understanding of the reasons underlying those principles and the applicability or inapplicability of those reasons to cooperatives. The fable of the three blind men's impressions of an elephant holds a pointed moral for judges and lawyers approaching the problems of cooperative corporation law and, particularly, the problems of financial structure and operation of cooperatives. Revolving capital cannot be assumed to result from the creation of either an exclusively debtor-creditor relationship or an exclusively corporation-shareholder relationship. Rather it involves a blending of certain elements of both, and frequently something new has been added as well. The resultant product is *sui generis*. In the long run, the public interest will best be served by thorough, patient, and understanding comprehension of what participants in a cooperative enterprise are trying to achieve, rather than by unwarranted assumption that new legal relationships arising from cooperative business transactions and organizations must be neatly and quickly, albeit somewhat forcibly, classified according to pre-existing legal concepts developed under different conditions for different purposes in different kinds of transactions and organizations.

Nieman, Revolving Capital in Stock Cooperative Corporations, 13 Law and Contemporary Problems 393 at 402 (1948).

The taxpayers are incorporated farmers' cooperatives. In issue is the tax treatment of amounts which they have paid for Class C stock which they hold of the New Orleans Bank for Cooperatives, an incorporated stock cooperative of which they are members and from whom they borrow.[1] The taxpayers say on the one hand that the amounts were not paid for a capital asset, which under 26 U.S.C. (1964 ed.) § 1221 is "property held by the taxpayer" (with designated exceptions none of which is contended to be applicable). They say that in truth all or substantially all of the amounts paid, though cast in the form of the purchase price of capital stock, really were amounts which they had contracted to pay for the use of borrowed money and therefore were interest.[2] As probative of both of these contentions their underlying argument is that the Class C stock lacks many of the usual characteristics of stock and that it has only nominal value. The government contends the stock is a capital asset, and, recognizing that it may not have fair market value in the usual sense of a willing buyer and a willing seller, says it has intrinsic value.

Once one grasps the function of this particular stock in an institution organized by the Congress as a cooperative[3] it is seen that the stock is a capital asset, "property held by the taxpayer," although it does not have the usual

1. The purchases were made by Coastal between 1958 and 1963 in the total amount of $211,799.68, and by Mississippi Chemical between 1961 and 1963 in the total amount of $55,113.19. Tax refunds ordered by the District Court are $265,044.35 to Coastal and $85,298.51 to Mississippi Chemical.

2. E.g. *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 76 L.Ed. 484 (1932).

3. Under a charter issued by the Farm Credit Administration.

characteristics of stock in a commercial enterprise organized under general corporation laws. Once that is seen —if not before—the contention that the payments for Class C stock are interest falls.

The Eighth Circuit, in *M.F.A. Central Cooperative* v. *Bookwalter*, F.2d [8th Cir., No. 19,527-531, June 8, 1970], has reached the same conclusion which I reach. That court held that the required quarterly investments in Class C stock were payments for capital assets. It affirmed the holding of the District Court[4] that the payments were not interest, and reversed the holding that they were ordinary and necessary business expenses. In so doing it considered *Penn Yan Agway Cooperative* v. *United States*, 417 F.2d 1372 (Ct. Cl. 1969) and the District Court opinion in the present case and would not follow them.[5]

1.

Central to this case is the fact that the New Orleans Bank for Cooperatives is itself a cooperative. "A cooperative is an association which furnishes an economic service without entrepreneur profit and which is owned and controlled on a substantially equal basis by those for whom the association is rendering service. . . . '[E]ntrepreneur profit' . . . really represents the antithesis of the benefits normally ascribable to cooperatives. 'Entrepreneur profit' is used in the true economic sense of a return for the speculative or risk element in an enterprise. In a cooperative, all the members assume, in a broad sense, the economic risk, and they contemplate no return for the undertaking of the risk." Packel, The Law of Cooperatives, § 1, pp. 2-3 (3d ed.).

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4. *M.F.A. Central Cooperative* v. *Bookwalter*, 286 F. Supp. 956 (E.D. Mo. 1968).

5. *Penn Yan* held that the purchase price of Class C stock was interest to the extent that it exceeded $6.60 per share, which the taxpayer conceded was its value.

"The primary objective of an ordinary cooperative is not charitable. . . . In the normal case . . . the cooperative is designed to further the economic interest or welfare of its members. Economic welfare does not merely refer to financial savings or increased monetary returns. It cuts much deeper and takes into consideration basic aspects of economic life. Quality of product, decency of service, ownership, control and satisfaction of self-help are important benefits of cooperatives and sometimes are even more important than the direct financial benefits." *Id.* at pp. 6-7. Among the normal attributes of a cooperative are:

* * * * *

(3) transfer of ownership interests is prohibited or limited;

(4) capital investment receives either no return or a limited return;

(5) economic benefits pass to the members on a substantially equal basis or on the basis of their patronage of the association;

Id. at 3.

Justice Brandeis pointed out in his dissent in *Frost* v. *Corporation Commission,* 278 U.S. 515, 536, 73 L.Ed. 483, 495 (1929) that farm cooperatives seek, in addition to the immediate and direct financial advantage of members, a type of economic democracy as well in which there is equitable assumption of responsibilities and equitable distribution of benefits, and that in addition to financial benefits they promote and effect cooperation among farmers. These objectives, coupled with that of economic strength springing from the combination in a single institution of the combined effort and contributions of all, is important in grasping the relationship between the appellant cooperatives and the cooperative financial institution from which they borrow.

2.

As Professor Nieman points out, the capital of a cooperative, insofar as permanence or impermanence of shares of stock or other units of capital is concerned, is essentially different from the capital of other business corporations.[6] The commercial shareholder does not anticipate his contribution to capital will be returned to him until dissolution. Prior to dissolution he can recover his contribution by selling his shares to another.

> A cooperative's capital, however, more often represents essentially a loan or temporary contribution by its patrons to finance certain economic services for them. The patron-member or patron-shareholder expects that the capital which he contributes will be returned to him prior to dissolution, but not until his own and other patrons' subsequent contributions to capital render his earlier contribution unnecessary to finance the cooperative's facilities and operations. He does not expect to wait until dissolution, and he knows that his shares are not readily salable. He looks to the cooperative to return his capital contributions to him if, and as soon as, it can do so.

Nieman, supra, at 393-94. This concept is a formalization of early, informal cooperative arrangements.[7] As cooper-

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6. Nieman, *supra,* at 393.

7. "When more than a century ago, a group of Ohio farmers joined together to ship their cattle to market at Pittsburgh, each of them presumably furnished his share of the cattle, wagons, and equipment which were the capital for the expedition; and each participant's capital was returned to him upon the completion of the project. The horses, wagons, machinery, and labor required for barn raisings or threshing were furnished by the participants, and were returned to them after each job or threshing season. Each participant ceased to provide such capital, and capital previously furnished was returned to him; when he ceased farming and, thus, no longer had need for the barn-raising or threshing services and equipment of his neighbors. In such informal, cooperative enterprises, the temporary nature of the capital employed was plain."

Id. at 394.

atives became more permanent and more continuous in their operations the patron who temporarily put his capital at the service of the group, footnote 7, *supra*, no longer took it home with him when his transaction was over but left it for the use of the continuing activity, though not for its permanent use. But the bedrock principle remained that he received no return or a limited return on his investment in capital.

Most of the formalized early cooperatives were corporations, which organized and structured their capital under the general corporation laws, the only laws available, though unrelated to the particular capital requirements of the cooperative. *Id.* at 393 and 395. "There ever since has been a trial-and-error effort to develop for cooperatives a kind of capital more adequately suited to their peculiar needs and still within the corporate form." *Id.* at 395.[8]

As cooperatives evolved, necessity imposed the creation of a new kind of temporary or interim capital, revolving fund capital.

Provision frequently was made for the return of a member's share of the capital upon the termination of his membership. The risk to the cooperative's financial integrity in the event that a substantial number of members should withdraw and demand the return of their membership capital at the same time required modification of the right to demand a return of membership capital promptly upon termination of membership. Provision was made to suspend the rights and privileges of membership or to retain the member's share of the capital until such time as the cooperative should be financially able to pay it out without

8. Today, in most jurisdictions, a cooperative can incorporate either with or without capital stock. Packel, *supra*, § 5(c) at p. 35.

undue prejudice to other members or creditors. The problems incident to the existence of permanent capital, even membership capital repayable upon termination or suspension of membership or reasonably soon thereafter, eventually were met by the creation of a new kind of temporary or interim capital which has now become quite common, although peculiar to cooperatives—that is, revolving-fund capital. *Id.* "The revolving fund plan 'has been likened to a water wheel, picking up water, using it to create the power that turns the mill machinery, and returning the water to the millstream.'" *Id.* at 396. As the fund of capital becomes adequate it is maintained at that level by continuing to receive each year new contributions to capital by current patrons, and to the extent that new contributions increase the capital above that needed the excess is returned to the patrons who made the earliest contributions. Necessarily there is some awkwardness in the use of shares of stock in a cooperative with revolving capital, but these are tempered by employing different classes of shares. *Id.* at 398-402.

The relationship of the stock cooperative to the member-stockholder who contributes capital is not strictly debtor-creditor, for there is no loan with a maturity date, nor corporation-shareholder in the commercial sense. Though styled corporation-shareholder it is in fact *sui generis*. Nieman, *supra*, at 397 and 402.

3.

It is against this background of recognized principles of cooperative organization and operation that Congress has established a comprehensive farm credit system, which is but a part of a broader program of encouraging the organization and development of effective cooperatives.[9]

9. Packel, *supra*, § 60, p. 275 et seq.

The cornerstone was the Federal Farm Loan Act of 1916,[10] establishing the federal land banks with goals of providing low cost farm credit, promoting farmer ownership of the banks, and established and stimulating among farmers cooperative effort.[11] Farmers could not borrow directly but were required to form national farm loan associations, which, operating on cooperative principles, would serve as middlemen in securing loans. These cooperative associations were required to purchase stock in the federal land banks in amounts relating to the size of loans (5 per cent of face.)[12]

The Farm Credit Act of 1933[13] established a much broader structure of farm credit around the original twelve federal land banks. Among the new institutions were the Central Bank for Cooperatives and twelve regional banks for cooperatives which had the specific function of lending to farmers' cooperatives. The initial capital, comparatively nominal, was furnished by the United States in the form of $110 million, divided between the twelve regional banks and the Central Bank.[14] Each regional bank had but one class of stock. Each borrowing cooperative had to become a member of the regional cooperative bank and a contributor to its capital by purchasing stock (or subscribing to a guaranty fund) in an amount related to the size of his loan. The purchase price of the stock was paid when the loan was closed, either by being deducted from the pro-

10. 39 Stat. 360.

11. S. Rep. No. 144, 64th Cong.; 1st Sess. pp. 2, 4 and 10.

12. The Senate Report said of this requirement:

"At the outset we secure the personal interest of the borrower by requiring him to contribute to the capital of the loan association 5 per cent of the face of his loan. This personal stake makes the . . . borrower a cooperator."

S. Rep. No. 144, *supra*, p. 10.

13. 48 Stat. 257.

14. 2 U.S. Code & Admin. News 1955, p. 2949, at 2950.

ceeds or added to the amount of the loan. However, upon repaying his loan a borrower could withdraw his contribution to capital by demanding redemption of his stock. These withdrawals caused the capital funds remaining in the banks to be insufficient to permit them to operate on a sound basis and to meet the needs of the farmer cooperatives for credit.[15] This is the difficulty which, as Professor Nieman points out, gives rise to revolving fund capital. In 1955 Congress changed the capital structure of the 12 regional banks and the Central Bank for Cooperatives to the revolving fund system.

The Farm Credit Act of 1953 required a study of methods by which to effect increased borrower participation in the management, control, and ultimate ownership of institutions operating under the permanent system of agricultural credit available through the Farm Credit Administration. 2 U.S. Code & Admin. News 1955 at 2947, 2949. The Farm Credit Act of 1955, 69 Stat. 655, which overhauled the entire system of farm credit, was the result of that study. The Senate Committee reported that the House Bill (in no relevant aspect different from the Senate Bill or the Act as passed) "would be a forward step in the goal of having private borrowers owning and managing these credit agencies." *Id.* at 2948.

The House Committee Report described the purpose of the legislation in this way:

> The primary purpose of title I of the bill is to provide a plan under which the banks [for cooperatives] would be organized on a truly cooperative basis. Borrowing cooperatives would continually make capital contributions to the system so long as they used its credit service. Each year final net savings (after taxes, dividends, reserves, and surplus requirements)

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15. 2 U.S. Code & Admin. News 1955 at 2951; *Penn Yan, supra,* at 1374.

> would be distributed as patronage refunds to borrowing cooperatives in the form of capital stock, all of which capital would remain in the system until all of the capital stock of the United States had been retired. Each year Government capital would be retired in an amount equal to the required stock contributions of and the patronage refunds to the borrowing cooperatives.

Id. at 2951.

The Act established a pure revolving fund capital structure. *Penn Yan, supra*, 417 F. 2d at 1374. It created Classes A, B and C stock, A owned by the government (nonvoting and no dividends); B owned by investors (nonvoting but dividend paying), and C (voting but only one vote to a member, no dividends). 12 U.S.C. § 1134d. Each year, as capital is added through investment in Class C shares by each borrower, and through distribution to borrowers of patronage refunds in the form of Class C shares, an equal amount of Class A shares is retired. Retirement of Class C shares will commence when all Class A stock has been retired, except that as Class C is retired all earlier issued Class B must also be called for retirement.[16] There is no retirement of stock on demand.

In lieu of the one-time purchase of stock previously required of each borrower, the 1955 Act substitutes a system of scheduled purchases of Class C stock. "[E]ach borrower . . . shall be required to invest quarterly in class C stock an amount equal to not less than 10 nor more than 25 per centum . . . of the amount of interest payable by it to the bank during the calendar quarter. Payment for such stock shall be made quarterly or when the regular interest payments of the borrower are payable." 12 U.S.C. § 1134 d.(a) (3). Prior to the 1955 Act required purchases

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16. The Class B shares are of nominal importance. In 1963 they constituted only approximately 5 per cent of total stock outstanding in the New Orleans Bank.

were unrelated to interest but keyed to the amount of the loan. Post-1955 purchases are keyed to interest only as a measure of the amount of stock to be purchased. It is obvious that they are keyed to payments of interest for convenience of billing and payment—the borrower pays his scheduled contribution to capital when he makes his interest payment, whether quarterly or otherwise. Amounts due for interest and investment in stock are rendered in the same bill, although separately stated and identified. A borrower who owns Class B stock and does not want to make the required investment in Class C stock by paying cash can convert his Class B to Class C. 12 U.S.C. § 1134 d(a) (3). This has been done by the New Orleans Bank in many instances, always on a dollar-for-dollar basis, $100 par value of Class C for $100 par value of Class B.[16a]

Pre-1955 stock can be converted to Class B or Class C. This has been done on the same basis of dollar for dollar of par value. Some holders of pre-1955 stock have been allowed to apply the full par value thereof against their loans outstanding.

The bank has a statutory lien on the borrower's Class C stock. In cases where it has been exercised against a defaulting borrower, the full par value of the stock has been applied to the loan balance.

In 1956, promptly after the 1955 Act went into effect, the New Orleans Bank established 15 per cent of interest payable during the quarter as the amount of quarterly in-

16a. The necessity of not being hypnotized by the phraseology of the commercial corporation is pointed up by 12 U.S.C. § 1134 d(b). If a borrower is not authorized under the law of the state of its organization to take stock in the bank, it must deposit in the "guaranty fund" of the bank the amount it would have invested in stock. This is the contribution to capital by the cooperative patron in its pure sense, unencumbered by share of stock conceptualism. Patronage refunds to such a borrower are credited against its contributions to the fund. Its deposit is returned to it in the same manner as Class C stock is redeemed.

vestment in stock required of the borrower. It did so pursuant to a policy determination that it hoped to retire all Class A stock by 1976, a 20-year period, and projected the 15 per cent figure as sufficient to achieve that. Retirement has been carried out each year as planned except that the rate of retirement has been better than expected. By 1963 Class A stock had been reduced from the 1956 level of $7,000,000 to $4,880,000, as against the projected level for that year of $5,150,000. In 1966 the Bank estimated informally that all Class A stock would be retired by 1972 or 1973.[17]

4.

Purchase of a single Class C share is a prerequisite to eligibility to borrow from the bank. 12 U.S.C. § 1134 d(a)(3). The District Court, the majority in this case and the court in *Penn Yan* viewed the purchase of this single share as conferring upon the purchaser the full spectrum of benefits that could flow to it from stock ownership, so that no additional benefit could accrue by its securing a loan and, as an incident thereof, purchasing additional stock as required. This misses the whole point of the cooperative structure of the banks. The thrust of the Congressional scheme is the promotion of permanent institutions to supply low cost credit to farmers' cooperatives and to foster the creation of additional cooperatives.[18] Ownership of the bank ultimately will be in the cooperatives. They will also participate in management, to the extent of

17. The supplemental brief of the United States quotes from an exhibit in the *M.F.A.* record which states that five of the regional banks have retired all Class A stock and that it is anticipated that all others will accomplish full retirement of the government's investment by 1971.

18. The 1963 report of the New Orleans Bank states that more than half of the cooperatives regularly financed by it are the outgrowth of conferences held by its staff with groups of farmers contemplating the establishment of new cooperatives.

the private sector of the joint government-private management scheme. A purchase of Class C stock does not increase the capital of the bank or its current lending capacity, since Class A stock in a like amount is retired. But each purchase moves the bank toward its ultimate institutional status as a farmer-owned cooperative supplying low cost farm credit to these taxpayers and others like them. The government "primed the pump" by "revolving in" the initial capital of a joint government-private undertaking, the societal values of which it is not the judicial function to question, and from which the government's capital was designed ultimately to be wholly "revolved out." To view the process of replacing government capital by private capital, as do taxpayers, as producing no benefit to anyone except the government which gets its money back, is to misunderstand both the purpose of Congress and the institutional value of the cooperative bank to the cooperatives which will own it and borrow from it.[19]

There are institutional values other than that of continued availability of low cost credit. There is the inherent cooperative concept that it is beneficial to channel into a single integrated effort the assets and needs of the group of patrons. There is the benefit of simple economic power, through ultimate substantial ownership of the es-

19. The benefit to these taxpayers, of the New Orleans Bank as a source of low cost credit, is quickly seen by a look at the years here in question. Their purchases of Class C stock for these years were, in round figures: Coastal (1958-63)—$11,700; $33,900; $47,100; $41,700; $35,000; and $42,100. Mississippi (1961-63)—$18,900; $16,800; and $19,300. Each purchase represents 15 percent of the interest paid for the year. Interest usually was between 4 and 5 percent. A simple calculation reveals the massive extent of the loans which they were enjoying.

From its organization through fiscal 1963 the New Orleans Bank made loans to its limited class of borrowers in its region (Louisiana, Mississippi and Alabama) of more than 618 million.

tablished, fully capitalized, staffed, and accepted financial institution.[19a]

Other benefits are perhaps more easily perceived because in the more conventional garb of dollars. As borrowers, taxpayers qualify for patronage refunds, distributed to them annually in proportion—as in all cooperatives—to their use of the services offered, thus in this instance measured by interest paid. In 1958-63 Coastal received patronage refunds in Class C stock of $289,-309.81. In 1961-63 Mississippi received $81,272.57. Together these are 14 per cent of *all* Class C stock (purchases and refunds) outstanding at the end of fiscal 1963. When their purchases of Class C stock for those years are added, it is revealed that together the taxpayers owned 24 per cent of the outstanding Class C stock.

Also each bank allocates on its books each year to each patron, in proportion to interest paid by the patron, a portion of the amount by which the bank's contingency reserves exceed its needs.[20] For the same years as above, Coastal was allocated from surplus $127,748.62, Mississippi $35,771.48. This "allocated surplus" eventually is distributed in the form of Class C shares.[21] The patronage refunds and the allocated surplus are not a return of the borrower's contributed capital but distributions of earnings, not presently convertible to cash but in due

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19a. Also it should be noted that the major source of loan funds for each bank is not its capital but funds which it obtains by borrowing from the Central Bank and the federal intermediate credit banks and by sale of debentures in cooperation with other regional banks. This access to low cost funds, and government-assisted credit, continues after Class A stock is retired.

20. Included therein are like distributions which the regional bank receives from the Central Bank for cooperatives.

21. The separate increments of value represented by the Class C stock (purchased and patronage refunds) and the allocated surplus are pointed out in Columbia Bank for Cooperatives v. Lee, 368 F.2d 934 (4th Cir. 1966).

course "revolved out" of the cooperative capital into cash to the borrower.

These benefits are measured by the borrower's use of services. But he does not qualify for them by the act alone of borrowing, only by borrowing plus contributing to capital. Congress could have chosen other approaches. A large contribution to capital to become eligible for service was a possibility, but this would be inconsistent with the cooperative concept of nominal financial outlay to become a patron (a small membership fee for the nonstock cooperative, a small purchase of stock for the stock cooperative), with the real and substantial contribution to capital made in proportion to use of services. It would be inconsistent with the aim of fostering organization and growth of fledgling cooperatives. Congress could have required a large one-shot contribution when the loan is made, but it had discovered the disadvantages of this before 1955. It could have provided for adding to capital by higher interest rates carried forward into earned surplus, but this would be inconsistent with its purposes of offering low rates and at the same time shifting from government to private ownership through the normal revolutions of revolving fund capital.

5.

The *sui generis* stock of an incorporated cooperative need not have the same characteristics as ordinary commercial stock to be a capital asset. But the differences loom so large in the minds of the plaintiffs, of the District Court[22] and the majority in this court that brief comment is appropriate.

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22. The District Court, after emphasizing the differences, concluded that the stock "does not enjoy the usual attributes of shares of stock but are mere bookkeeping entries or devices." The District Court made no references to the peculiarities of cooperative financing. In fact its opinion does not even reveal that the New Orleans Bank is a cooperative.

No Class C stock certificates are issued. A form for the certificates has been approved by the Farm Credit Administration, but the Board of Directors of the New Orleans Bank exercised the discretion given them by the bylaws not to issue certificates. The Bank reflects on its stock ledger the amount of each type of Class C stock owned and at the end of each fiscal year notifies each owner of the amount owned at the beginning and end of the year.[23]

The stock has no dividend and no growth potential. This is normal for a cooperative.

Only the first share of Class C stock carries a voting right. "One person one vote" is a basic cooperative principle, which gives recognition to the concept of an economic democracy. Packel, *supra*, at 138-40.[24]

Class C shareholders will not enjoy sole control of the bank in the commercial sense even when all Class A stock is retired since they will not elect all directors of the joint board which administers it and other farm credit agencies of the region. This makes the stock different from some commercial stock[25] but no less a capital asset.

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23. This system of recording stock ownership without issuing certificates is no surprise to any holder of shares of almost any one of the major mutual funds which employ the same method for shareholders authorizing automatic reinvestment of dividends and which, like the New Orleans Bank, notify the shareholder periodically of how many new shares he has acquired.

A certificate of stock is not the stock itself but only evidence of ownership. The rights and duties between corporation and stockholder exist apart from the certificate. 11 Fletcher, Corporations, § 5092 (Perm. ed.).

24. The principle is carried forward into the Capper-Volstead Act under which a cooperative marketing association, if it wishes to enjoy immunity from the Sherman Act, must not allow a member more than one vote regardless of how much stock he owns. 7 U.S.C. §§ 291-292.

25. Commercial preferred stock often is nonvoting, and nonvoting common of many companies is traded daily on the stock exchanges.

The stock is not transferable except to other cooperatives and with the consent of the Bank.[26] This is usual in a cooperative. Packel, *supra*, pp. 3, 127. It is essential to keep out of the membership persons with interests antagonistic to the cooperative and is an effective means to keep patrons from transferring their interests at a profit. *Id.* at 127-128 and cases there cited.

6.

The majority center on, and repeatedly employ, the phrase "interest override," and even characterize the requirements of the statute in those terms. The term nowhere appears in the statute, the Congressional history, the loan agreements, or the quarterly bills sent taxpayers showing separately interest, principal and "C stock subscription." The President of the New Orleans Bank explained that the term had grown up in that regional bank and in turn had been picked up by its borrowers.

Class C stock purchased under the required investment provisions is shown in the stock ledger separate from that issued as patronage dividends, and under the heading "Investment in C Stock (Interest Override)." The President defined "interest override" as "the amount we require our borrowers to pay over and above interest for the purchase of C stock."

The promissory notes signed by taxpayers provide for interest. Each separate loan agreement provides:

> Stock Purchase: The association shall invest quarterly in class C stock of the bank at its fair book value, not exceeding par, an amount equal to 15 per

26. There have been a few approved transfers incident to liquidation, merger or accommodation between cooperatives.

But compare Columbia Bank for Cooperatives v. Lee, 308 F.2d 934 (4th Cir. 1966), stating that once issued Class C stock is transferable to any person.

cent of the amount of interest payable by the association to the bank on said loans for said calendar quarter or part thereof. The association shall pay for said class C stock on the date interest is due and payable. . . .

7.

The plainly erroneous rule applied to the finding of the District Court that the Class C stock has only nominal value, may not be the basis of an affirmance. What has been said makes clear that the stock has, as the Eighth Circuit concluded in *MFA*, an intrinsic value. Also it is apparent that the District Court's finding was based on the erroneous basis of comparing the stock, characteristic by characteristic, with that of the usual commercial corporation and totally overlooking its value as a capital contribution to a cooperative under the plan of the Congress.

On the issue of value, in *Columbia Bank for Cooperatives* v. *Lee*, 368 F. 2d 934 (4th Cir. 1966), a bankrupt cooperative owned Class C stock of the Columbia regional bank with a par value (in round figures) of \$54,200, Class B stock with a par value of \$45,800, and there had been allocated to the bankrupt surplus of \$13,000, total \$113,000. The referee ordered the bank to allow a setoff of this \$113,000 against the cooperative's indebtedness to it of \$162,000, and the District Court affirmed.[27] Another cooperative had offered to buy the stock for \$50,000, which was 45 per cent of its par value and allocated surplus. The Fourth Circuit held that the bank was not required to offset at par value and remanded for valuation by the referee. It declined to accept the single offer of \$50,000 as a reasonable reflection of true value and noted, "However thin the general market for these shares may be, the

27. The New Orleans Bank in many instances has made just such a full offset without legal proceedings.

continuing stream of borrowers from the bank provides it with a ready market." 368 F. 2d at 940.[28] The Columbia Bank projected retirement of all Class A stock by 1967. New Orleans Bank stock may be worth less than 45 cents on the dollar because of the difference between projected 1967 retirement of Class A and projected 1972-1973 retirement. But the discount is not to $1.00 per share or less. In the present case an expert familiar with cooperative financing presented a full and careful analysis of Class C stock of each year separately and assigned values ascending from $3.42 per share for 1958 Class C stock to $38.65 per share for that of 1963.

8.

My brothers have, in Professor Neiman's terms, felt the leg of the elephant and concluded that the beast is interest. A look at the concept of cooperatives, the legislative history, the expressed intent of Congress, the language of the statute, the books and records of the parties and the loan agreements signed by the taxpayers, reveals that it is an elephant after all. I would join with the Eighth Circuit and would reverse.

28. On remand (not officially reported) no valuation by the referee was necessary. The parties agreed that the trustee would receive a credit in the amount of the value of bankrupt's stock plus allocated surplus, a total of $112,694.97, and the trustee agreed to pay the bank cash of $49,305.03, which was the balance of the bank's claim.